No. 14,047.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

RALPH H. EATON FOUNDATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Review of Decision of the Tax Court of the United States.

BRIEF FOR THE PETITIONER.

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TABLE OF AUTHORITIES CITED

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BRIEF FOR THE PETITIONER.

This case involves the question as to whether a corporation is liable for income taxes or whether it is exempt therefrom.

Opinion Below.

The opinion of the Tax Court of the United States is found at R. 28, and is reported at C. C. H. Memo. T. C., Par. 19490(M).

Jurisdiction.

The jurisdiction of the Tax Court was based on Internal Revenue Code Section 272. The decision of that Court was entered on June 8, 1953.

The jurisdiction of this Court is based on Internal Revenue Code Sections 1141 and 1142. Petition for Review by this Court was filed in the Tax Court on August 17, 1953. Venue in this Court is established by Internal Revenue Code Section 1141(b), and the fact that the returns of the tax in respect of which the alleged liability arises were filed with the Collector of Internal Revenue at Phoenix, Arizona, within this Circuit.

Statute Involved.

The statute involved is Internal Revenue Code Section 101(6) which, during the tax years involved herein, read as follows:

> "The following organizations shall be exempt from taxation under this chapter—
>
> "(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;" * * *

Question Presented.

Is a corporation exempt from income tax under Internal Revenue Code Section 101(6) where, although it operated businesses for profit, its purpose and intention in so doing, as expressed by its Articles of Incorporation and by the individuals who founded the corporation and comprised its Board of Directors, was to devote that profit to charitable and religious ends?

Statement.

Petitioner is in accord with all of the facts found by the Tax Court [R. 29 to 38]. However, there are additional facts which petitioner contends the Tax Court was entitled but failed specifically to find. The statement which follows will summarize the facts as specifically found by the Tax Court and will supplement the same with concise statements of additional uncontroverted facts which are relevant to this appeal. Such additional facts will be supported by references to pages of the Transcript of Record forming a part of the record on appeal in this matter.

Ralph H. Eaton joined the Capital Christian Church of Phoenix, Arizona, in 1931, and became a member of the official board of the Church in about 1933. He is a life member of Gideons International. He is a director of the Arizona Bible Institute and the Phoenix Central High School, a member of the Layman's Advisory Council of the National Association of Evangelicals, and on the advisory boards of Christ for America, the American Soul Clinic and Bob Jones University of Greensville, South Carolina. In 1944, while attending an international convention of the Christian Business Men's Committee in New York City, Eaton heard a speech by an industrialist who had contributed money to charities and Christian work through his own charitable foundation. Thereafter, he read a book by the same individual which further described the part played by religion in his business pursuits.

Mr. Eaton thereupon discussed with his wife the matter of forming a foundation of his own. Mrs. Eaton was definitely interested [R. 7] since Mrs. Eaton's interest in Christian work has always coincided with that of her husband.

Mr. and Mrs. Eaton had known Thomas H. Kent, Jr., since about 1937, having been members of the same Church and many religious and charitable organizations together. Mr. Kent was not related to the Eatons. He had graduated from Butler University and had come to Phoenix in 1939. He went to work for the Eaton Fruit Company in 1941 and joined the Eaton-Heiskell Construction Company in 1945 as a bookkeeper.

For about two years prior to March, 1947, Mr. Kent and the Eatons had discussed the formation of a charitable foundation. In these discussions Mr. and Mrs. Eaton took into account the fact that their family lived on a moderate income and that their interest above that was "to give to the Lord's work" [R. 8]. Mr. Eaton's principal source of income was the Eaton Fruit Company, a business owned by him and his two brothers. It provided an income that was sufficient for Mr. Eaton and his family [R. 8].

In or about February, 1947, the Eatons and Kent consulted with Robert Weaver, a duly licensed attorney, of Phoenix, Arizona, for the purpose of organizing petitioner. All details of the Articles of Incorporation except Article IV (quoted below) were left to Weaver for formulation.

In March, 1947, the petitioner corporation was organized under the laws of the State of Arizona.

Petitioner's incorporators were Mr. and Mrs. Eaton and Kent. They were elected directors of petitioner and also president, vice president and secretary-treasurer, respectively, which positions they still held in May, 1952. Petitioner has no capital stock outstanding and no subscriptions thereto. The Articles of Incorporation expressly prohibit the issuance of capital stock.

Petitioner's Articles of Incorporation describe the nature and purpose of its proposed business as

> "To foster and promote Christian, religious, charitable and educational enterprises."
>
> * * * * * * * *
>
> "This corporation * * * does not contemplate pecuniary gain or profit to the members thereof. * * *"

The Articles also set forth in Article IV a doctrinal statement describing the foundation upon which this corporation is based. Article IV had been the subject of numerous deliberations among the Eatons and Kent for some time, and read as follows:

> "Article IV.
>
> "The foundation upon which this corporation is based is a heart-conviction of the truth of the following Doctrinal Statement:
>
> "1. We believe that the entire Bible is the inspired and inerrant word of God, the only infallible rule of faith and practice.
>
> "2. We believe that the Lord Jesus Christ is the only begotten Son of God, conceived by the Holy Spirit and born of the Virgin Mary.
>
> "3. We believe in the literal, bodily, physical and premillennial return of Jesus Christ.
>
> "4. We believe in the sacrificial and vicarious death of the Lord Jesus Christ on the cross and that He thereby made perfect substitutionary atonement for the sin of the world.
>
> "5. We believe that all men are sinners and in an eternally lost condition apart from the saving grace of the Lord Jesus Christ.
>
> "6. We believe that acceptance into the family of God and eternal salvation can only be secured by

believing in and by faith accepting and receiving the Lord Jesus Christ as personal Sin-bearer, Lord and Saviour."

Petitioner's Articles direct that each director must reaffirm the doctrinal statement annually, in writing, and that the reaffirmance be filed with petitioner's permanent records. Failure, refusal or neglect to comply with this directive automatically divests the director of his office. The three directors did in fact reaffirm the doctrinal statement during the periods in controversy.

Mr. Eaton's purpose in causing the formation of petitioner was to foster and promote Christian, religious, evangelistic, missionary endeavors and enterprises, and Mrs. Eaton's purpose coincided therewith [R. 7]. Kent, being also interested in Christian work, desired to help the Eatons to establish petitioner and to further the purpose for which it was established [R. 21, 22].

The Eatons and Kent, at the time of the formation of petitioner, discussed the fact that, for petitioner to fulfill the purposes for which it was founded, it would have to receive gifts and would have to enter into various "phases of business that would produce income for the purpose of giving it to these Christian organizations that we had an interest in and a desire to help" [R. 9].

Accordingly, during the periods in controversy, petitioner was engaged in four different businesses: Farming, selling real estate, constructing small residences, and selling sport clothes. Petitioner's directors discussed its business activities fully before undertaking each of them, and were completely agreed on petitioner's course of action in all cases.

To enable petitioner to engage in these businesses, Mr. and Mrs. Eaton transferred certain properties to petitioner. Thus, to enable petitioner to engage in farming, Mr. and Mrs. Eaton in March, 1947, transferred to petitioner certain farm and office equipment which had been purchased by them within the previous six months at a total cost of $1,843.66. The Eatons also transferred to petitioner their right, title and interest in certain growing crops against which they had advanced the sum of $3,520.79, which sum petitioner agreed to repay to the Eatons.

To enable petitioner to engage in the business of selling real estate, the Eatons in April, 1947, transferred their interest in certain trusts to petitioner. These trusts owned 110 acres of subdivided land on West McDowell Road in Phoenix, Arizona, and the Eatons owned a 9/10ths interest in these trusts. The net cost of the interest turned over by the Eatons to petitioner was $27,410.62.

To enable petitioner to engage in the construction business, Mr. Eaton transferred to petitioner, on January 1, 1948, his partnership interest in Eaton & Heiskell Construction Company, a business engaged primarily in contracting the construction of small residences. The Eaton & Heiskell Construction Company had commenced business in 1945 when Eaton entered into a partnership with George M. Heiskell. In January, 1948, petitioner purchased Heiskell's interest in the Company for its book value and it was at that time that Eaton transferred his interest in the Company to petitioner as aforesaid.

The total cost to the Eatons of the transfers to petitioner of the farm and office equipment, the trust inter-

ests, and the partnership interest in Eaton & Heiskell Construction Company aggregated approximately $50,000.00.

All of the transfers above described were given to petitioner without consideration, and said gifts were duly accepted by the Board of Directors of petitioner on the day when said gifts were made [R. 3, 4 and 5 (Stip. Par. 12(a), 13(a), 14(c))].

Petitioner's farming operations were conducted on land held under five leases. Under a lease dated March 20, 1947, petitioner leased from Eaton 80 acres of land known as the L Avenue Ranch for one year beginning February 1, 1947, at a rental of $40.00 per acre per year. This lease was renewed for another year at its expiration at the same rental. The original rental and the renewal were authorized by petitioner's directors. The L Avenue Ranch was formerly leased by Eaton to the Eaton Fruit Company at the same rental later paid by petitioner. Petitioner further leased land known as the Swant Ranch from E. H. Swant for one year beginning July 1, 1947, at a rental of $30.00 per acre per year. On or about July 1, 1948, Eaton purchased the Swant Ranch and entered into a new lease between himself and petitioner for one year beginning July 1, 1948, at a rental of $40.00 per acre per year. On or about April 1, 1948, Eaton purchased 40 acres of farm land on Ramona Road, Phoenix, Arizona, and leased 35 acres thereof to petitioner for a period of one year beginning April 1, 1948, at a rental of $40.00 per acre per year. Petitioner also leased from one Lovell T. Rousseau a ranch known as the Rousseau Ranch for a term of approximately six months beginning July 1, 1948, and at a rental of $60.00 per acre per year. Petitioner leased a certain ranch known as the Mann

Ranch from T. A. Mann for a term of one year beginning August 1, 1947, at a rental of $35.00 per acre per year. This lease was renewed at its expiration for an additional six months, at a rental rate of $45.00 per acre per year. All of these leases and their renewals were authorized by petitioner's board of directors.

Petitioner's farming operations were managed by one L. E. Eastes pursuant to a contract entered into with petitioner for one year beginning February 1, 1947, and subsequently extended for another year. Eastes is not related in any way to the Eatons or Kent, nor does he own any legal or beneficial interest in petitioner.

Petitioner's net income from its farming operations during the periods in controversy was as follows:

3/12/47 to 1/31/48	$16,731.14
2/1/48 to 1/31/49	7,095.23

Eaton charged petitioner for the rental of his lands because of financial necessity. He had purchased the Swant Ranch and Ramona land on an installment basis, and his combined payments per year, including amortization of principal on these properties were more than three times the rental he received from petitioner. He also expended substantial sums in improving these properties.

The rentals which were charged by Eaton were determined on the basis of, and never exceeded, the average rental in the area for comparable property, taking into account the improvements, location, fertility of the soil, water availability and land value [R. 10 to 15]. Kent knew all rents charged petitioner by Eaton were proper [R. 23].

Petitioner's subdivision operations consisted of selling the subdivided lots contained in the land which had been

subject to the trust agreements. Petitioner's net income from these operations for the periods in controversy was as follows:

3/1/47 to 1/31/48	$49,089.41
2/1/48 to 1/31/49	2,784.06

Petitioner's construction operations commenced on January 1, 1948, when it purchased George M. Heiskell's interest and received a gift of Mr. Eaton's interest in the partnership known as Eaton & Heiskell Construction Company. Petitioner has operated the business under its original name since that time. Heiskell was employed to manage the business for petitioner under a written contract, the terms of which provided for one year of employment beginning January 1, 1948. The term was extended in fact for an additional month, to January 31, 1949. Heiskell is not related to the Eatons or to Kent. Petitioner derived the following net income from its construction operations during the periods in controversy:

3/12/47 to 1/31/48	(none)
2/1/48 to 1/31/49	$7,551.52

On June 2, 1947, pursuant to authorization of its directors, petitioner acquired the distributorship within the State of Arizona of certain sport clothes manufactured by one C. F. Smith. Petitioner operated this business under the name of "Hollywood Sportogs of Arizona," and was to receive 10 per cent of all gross sales. This business activity was discontinued on June 1, 1948, due to management difficulties and lack of sales. Petitioner incurred net losses from this business during the periods in controversy as follows:

3/12/47 to 1/31/48	($533.83)
2/1/48 to 1/31/49	(134.99)

In order to have money to operate, it was necessary for petitioner to borrow money from time to time from Mr. Eaton. Mr. Eaton, being short of funds, in turn borrowed the money at the bank in his own personal name and loaned it to petitioner. Since he had to pay interest to the bank, and since he could not afford making such payment without reimbursement, he requested petitioner to pay him, and petitioner did pay him, the amount of interest he had to pay to the bank [R. 15, 16]. The amount of interest due Mr. Eaton from petitioner was calculated by Kent [R. 22, 23].

Except for rental payments, interest on money borrowed, payments for costs advanced by Eaton on certain equipment and growing crops, and repayment of loans, petitioner paid nothing of tangible value to Eaton or to his family during the instant taxable years, despite the fact that Eaton had rendered substantial services to petitioner. Mrs. Eaton had also contributed a great amount of time and effort to the supervision of the activities of petitioner [R. 5 (Stip. Par. 16)].

In this connection the Eatons had made it plain from a time before petitioner was incorporated that there would never be any compensation to Mr. Eaton personally nor to his family, and neither Eaton nor his wife expect to receive at any time compensation for services rendered during the tax years in question [R. 16, 17].

In January, 1948, Kent became a salaried employee of petitioner. He has rendered substantial services to petitioner since that time, having acted as office manager, bookkeeper and business manager and having kept petitioner's minute book. The only compensation which Kent has received has been a weekly salary of $100.00 paid

him since January 1, 1948, when he began devoting his full time to petitioner's affairs.

During the tax years here involved petitioner has not engaged in carrying on propaganda or otherwise attempted to influence legislation [R. 17].

At a meeting of the directors on May 1, 1947, petitioner adopted a list of 26 named beneficiaries engaged in charitable or religious work to whom its funds would be made available, in its discretion. It also provided for contributions of not more than $10.00 by petitioner's president to miscellaneous organizations engaged in charitable and religious work, without necessity for consulting the Board. At a Board meeting held on January 1, 1949, seven additional named beneficiaries were added to petitioner's list. This list was compiled after a thorough investigation of the activities of each organization. Petitioner kept a file on each. All beneficiaries had to be and are engaged in activities which carried out the purposes and ideas for which petitioner was established. None of them is engaged in the carrying on of propaganda or in efforts to influence legislation. None of them has any private, beneficial or personal interest in petitioner. No beneficiaries are individuals; any names of individuals on petitioner's list appear as representatives of an organization. During the periods in controversy, petitioner made contributions to beneficiaries as follows:

3/12/47 to 1/31/48	$4,240.00
2/1/48 to 1/31/49	2,310.00

In addition to monetary contributions, petitioner rendered consultative services to some beneficiaries and petitioner's officers assisted in planning two church building programs.

The amounts contributed in the years in question were determined on the basis of the actual cash which petitioner

had available and the needs of the particular beneficiaries [R. 23-26]. There were times when petitioner's cash balance was less than $1,000.00 [R. 24, 25]; hence, petitioner did not have money available in order to make any larger contributions [R. 25]. Moreover, the pendency of the instant case made it advisable and necessary for petitioner, upon the recommendation of its attorneys, to keep some cash reserve in the event of an adverse decision [R. 27, 28].

There are no immediate plans for the dissolution of petitioner [R. 17, 26]. Should petitioner be dissolved, it was the understanding of Eaton and his family that none of the assets of petitioner would ever return to Eaton in any way [R. 17, 18]. The Eatons and Kent understood that the assets of petitioner were intended to go to the charities and Christian organizations approved by the Board of Directors of petitioner [R. 19, 26, 27].

On June 15, 1948, Eaton executed as president of petitioner an exemption affidavit. Question No. 16 thereof read as follows:

> "In the event of the dissolution of the organization, what disposition would be made of its property?"

The answer that was typed in was:

> "To be dispersed to charitable and religious organizations."

This represented Eaton's understanding of the situation at that time [R. 19, 20].

The Eatons relied upon their attorney to insure that there would never accrue to Eaton in any way, nor to his family, anything from the Foundation [R. 20, 21]. At the time of trial Eaton desired that, if petitioner's Articles

were inadequate to insure this result, they should be amended as quickly as possible [R. 19, 20].

Under this state of facts, the Tax Court rendered its decision on February 27, 1953, that petitioner was not exempt under Internal Revenue Code 101(6) and that there was owed from petitioner a deficiency of $23,263.05 for the period March 12, 1947, to January 31, 1948, and $1,223.88 for the fiscal year ended January 31, 1949.

The Commissioner had assessed a penalty for wilfull neglect in failing to file timely returns. The Tax Court found no wilfull neglect but rather reasonable cause and the penalty matter is therefore not in issue on this appeal.

Summary of Argument.

Petitioner was exempt from tax under Internal Revenue Code Section 101(6) even though it operated businesses for profit. It meets the four conditions laid down by that section: (1) petitioner was organized for one or more of the required statutory purposes; (2) petitioner did not engage in the carrying on of propaganda; (3) no part of the net earnings inured to the benefit of any private individual; and (4) petitioner was operated exclusively for one or more of the required statutory purposes.

Where the destination of an organization's income, though derived from business sources, was charitable and religious, many cases (before the 1950 Revenue Act) have decided that destination is more important than the source of the income in determining an exempt status. The legislative history of Internal Revenue Code Section 101(6) affirms the correctness of those decisions.

Petitioner's articles and the testimony of petitioner's founders make plain that the destination of petitioner's income was charitable and religious.

ARGUMENT.

Petitioner Meets All of the Conditions for Exemption Established by Internal Revenue Code Section 101(6).

Internal Revenue Code Section 101(6) lays down four conditions which must be met in order for an organization to be exempt in a particular taxable year. These conditions are:

(1) The organization must have been *organized* exclusively for one or more of the specified statutory purposes;

(2) No substantial part of its activities can consist of the carrying on of *propaganda* or otherwise attempting to influence legislation;

(3) No part of the *net earnings* of the organization inures to the benefit of any private individual; and

(4) The organization must be *operated* exclusively for one or more of the specified statutory purposes.

The Tax Court, in holding that petitioner was not exempt under Internal Revenue Code Section 101(6), did so because petitioner was engaged in business operations. While the Tax Court did not specifically indicate which of the four conditions above set forth it thus considered not to have been satisfied, it would appear analytically that its holding considers that the fourth, or operational, condition had been breached. Hence, it will be with that topic that the major portion of this brief will deal. It would be desirable, however, first to dispose of the remaining conditions which must be satisfied before considering the fourth and principal one.

A. Petitioner Was Organized for the Required Statutory Purposes.

There would appear to be no doubt, from any of the cases decided under Internal Revenue Code Section 101(6), that the "organized" test has been satisfied.

Some of the cases decided under that section state that the corporate charter is conclusive on whether the taxpayer was "organized" exclusively for the statutory purposes.

> See, *e. g., Cummins-Collins Foundation,* 15 T. C. 613 (1950).

Petitioner's corporate charter describes the nature and purpose of its proposed business as "To foster and promote Christian, religious, charitable and educational enterprises." The articles further provide, "This corporation * * * does not contemplate pecuniary gain or profit to the members thereof * * *" [R. 29]. If this specific language of petitioner's articles is to be accorded its natural legal significance, there is no conclusion possible other than that petitioner was "organized" exclusively for one or more of the required statutory purposes.

A majority of the cases on this point hold, however, that the term "organized" is not synonymous with "incorporated," and that evidence outside of the articles may be looked to in order to determine whether the taxpayer was organized for the required purposes.

> See, *e. g., Roche's Beach, Inc. v. Com'r,* 96 F. 2d 776 (C. A. 2d, 1938);
>
> *Goldsby King Memorial Hospital,* T. C. Docket 204, memo, op. 7/19/44;
>
> *Unity School of Christianity,* 4 B. T. A. 61 (1926).

(It may be noted that the cases which do look outside of the articles on this question involve taxpayers whose articles provided for purposes broader than those contemplated by the statute. That this is not true in the case of petitioner has already been discussed.)

An examination of the evidence available to this Court, outside of the articles themselves, shows that petitioner was organized in the required manner. Mr. Eaton's purpose in causing petitioner to be organized was "exactly as stated in the articles, foster and promote, Christian, religious, evangelical, missionary endeavors and enterprises" [R. 7]. Mrs. Eaton agreed with this purpose [R. 7]. And Kent, the third organizer of petitioner, being also interested in Christian work, desired to help the Eatons to establish petitioner and to further the purpose for which it was established [R. 21, 22].

That such evidence of intent and motive on the part of the founders is material to resolve the first, or organizational, test is apparent from the statutory use of the volitional word "purpose."

See, *e. g., Com'r v. Edward Orton, Jr., Ceramic Foundation,* 173 F. 2d 483 (C. A. 6th, 1949);

Cummins-Collins Foundation, supra.

B. Petitioner Did Not Carry on Propaganda.

It is assumed that no argument need be submitted on the proposition that petitioner did not engage in the carrying on of propaganda nor did it otherwise attempt to influence legislation. The record bears out that petitioner did not itself engage in such prohibited activities [R. 17]. Moreover, the Tax Court found that it did not support any organizations which were so engaged [R. 37].

C. No Part of Petitioner's Net Earnings Inures to a Shareholder or Individual.

It is to be noted that, while Internal Revenue Code Section 101(6) specifies that "net earnings" shall not inure to the benefit of private shareholders or individuals, the Regulations (Reg. 111, sec. 29.101(6)-1) have for a long time used the term "net income," and the Treasury Department may thus be considered as conceding that the two terms are synonymous. It requires no citation to authority to establish that the term "net income," in turn, means gross income less allowable deductions.

The most obvious instance of net earnings inuring to the benefit of a private shareholder or individual is the case where compensation is paid in an unreasonable amount to some person who has a private and personal interest in the organization's activities.

> *Mabee Petroleum Corporation v. Com'r,* 203 F. 2d 872 (C. A. 5th, 1953).

The Tax Court found, however, that Mr. and Mrs. Eaton rendered substantial services to petitioner but that, except for certain payments hereafter mentioned, petitioner paid nothing of tangible value to Eaton or to his family. Moreover, the Tax Court found that Kent rendered substantial services as a full time employee of petitioner for which he received a weekly salary of $100.00. While the Tax Court failed to make a finding as to whether this constituted unreasonable compensation, it is assumed that as a matter of law this Court could so hold (or that, if necessary, the case might be remanded for a specific finding on that subject).

The Tax Court further found that the Eatons sold to petitioner their interest in certain growing crops at a figure

equal to the amount which they had advanced against said crops. The record further shows that Eaton charged petitioner interest on money he lent to petitioner, but only in the amount which Eaton himself was called upon to pay to the bank from which he himself had borrowed [R. 15, 16]. Neither the payment for growing crops nor the payment of interest can seriously be contended to have been a distribution of petitioner's "net earnings" since they constituted legitimate deductions from gross income. Petitioner further assumes, without discussion, that the repayment of loans by petitioner to Eaton did not constitute a prohibited transaction.

There thus remains only the matter of rents paid by petitioner to the Eatons for the use of their farm lands which could by any possibility be considered as net earnings inuring to the benefit of a private shareholder or individual. Considerable testimony was adduced before the Tax Court on the reasonableness of the rent which Eaton charged petititoner. While the Tax Court made no specific findings on this subject, the evidence thereon was uncontradicted and has been reproduced as part of the Transcript of Record. This record shows that the rentals charged by Eaton were determined on the basis of, and never exceeded, the average rental in the area for comparable property, taking into account the improvements, location, fertility of the soil, water availability, and land value [R. 10-15]. Kent knew all rents charged petitioner by Eaton were proper [R. 23].

It is thus submitted that none of the "net earnings" or "net income" of petitioner inured to the benefit of any private shareholder or individual.

D. Petitioner Was Operated for the Required Statutory Purposes.

(1) The Case History of Internal Revenue Code Section 101(6) Shows That Destination Controls Over Source.

The Tax Court in the instant case relied upon the cases previously decided by that Court to support its position that the mere fact of business activity by petitioner was enough to destroy petitioner's claim to exemption, despite the charitable or religious destination of petitioner's income.

This point is one which has been profusely litigated and no purpose would appear to be served by an extensive review of the course of that litigation.

A majority of jurisdictions considering the question have held that the destination of the income is more significant than its source, and that the mere fact that an organization conducted a business activity was not sufficient to deprive it of an exempt status where all other requisite conditions are satisfied. The jurisdictions so holding and representative cases therefrom are:

United States Supreme Court: *Trinidad v. Sagrada Orden de-Predicadores,* 263 U. S. 578 (1924);

Second Circuit: *Roche's Beach, Inc. v. Com'r,* 96 F. 2d 776 (1938);

Third Circuit: *C. F. Mueller Co. v. Com'r,* 190 F. 2d 120 (1951);

Fifth Circuit: *Willingham v. Home Oil Mill,* 181 F. 2d 9 (1950);

Sixth Circuit: *Com'r v. Edward Orton, Jr., Ceramics Foundation,* 173 F. 2d 483 (1949);

Court of Claims: *Sico Co. v. United States,* 102 Fed. Supp. 197 (1952).

The Treasury Department itself has, at one time, concurred with this majority view.

S. M. 5516, C. B. V-1, p. 81;

I. T. 2296, C. B. V-2, p. 65;

G. C. M. 20853, 1938-2 C. B. 166.

No less an authority than Mertens in *Law of Federal Income Taxation,* Vol. 6, par. 34.19, (1949 Ed.) stated:

> "The proper test would seem to be the use to which the income is put and not its source."

This Court has had the matter before it in *Squire v. Students Book Corp.,* 191 F. 2d 1018 (1951) wherein this Court has indicated its agreement with the general rule, although it did not expressly so hold in that case. The only Circuit which rejects the destination test is the Fourth Circuit (*United States v. Community Services, Inc.,* 189 F. 2d 421 (1951)).

The Tax Court itself has held, until recently, that destination controlled over source. Three of the leading cases were:

Sand Springs Home, 6 B. T. A. 198 (1927);

Simpson Estate, 2 T. C. 963 (1943);

United School of Christianity, 4 B. T. A. 61 (1926).

In 1950 the Tax Court had before it the famous case of *C. F. Mueller Co.,* 14 T. C. 922, and in a divided opinion the majority of the Tax Court held, contrary to prior cases, that business activity of an otherwise qualified corporation served to remove its exempt status. The Tax Court has consistently held in accord with the *Mueller* decision, despite the reversal of the latter by the Third Circuit.

American Ass'n of Engineers Employment, Inc., T. C. Docket 22919, memo. op. 3/7/52; aff'd 204 F. 2d 19 (C. A. 7th, 1953);

Donor Realty Corp., 17 T. C. 899 (1951);

Danz, 18 T. C. 454 (1952);

Eastman Corp., 16 T. C. 1502 (1951).

Petitioner points to this history to show more than that a majority of courts considering the question at issue have disposed of it favorably to petitioner's position. An examination of the leading cases which have been cited above reveals the fact that in March, 1947, the date of incorporation of petitioner, there was not a *single* case which held that the mere operation of a business by an otherwise exempt corporation would destroy the exempt status. It can be safely assumed, in line with our philosophy of Anglo-American jurisprudence, that petitioner was organized by its founders in reliance upon the proposition that judicial precedent is, except in case of palpable mistake or error, overruled not by subsequent cases but only by subsequent legislation. This is the cornerstone of the doctrine of *stare decisis* and is based upon the principle that the law by which men are governed should be fixed, definite, and known. Acting in reliance, then, upon twenty-three years of holdings adhering to the principle of the *Sagrada* case, not only did the founders organize

petitioner but Mr. Eaton gave to petitioner property costing him some $50,000.00 [R. 33]. It was fully four years after petitioner was organized that the first decision adverse to the principles upon which Mr. Eaton and the other founders had relied was enunciated (*United States v. Community Services, Inc., supra*). It is submitted that, under these circumstances, the approach of *Willingham v. Home Oil Mill, supra,* invoking the doctrine of equitable estoppel is not only appropriate but requisite to a just adjudication in the instant case.

(2) The Legislative History of Internal Revenue Code Section 101(6) Shows That Destination Controls Over Source.[1]

The legislative source of Section 101(6) is the Act of Congress, August 5, 1909, Chap. 6, sec. 38, 36 Stat. 113, commonly known as the Corporation Excise Act of 1909.

The origin of the Corporation Excise Act of 1909 was a Senate Finance Committee amendment introduced June 25, 1909, by Senator Aldrich (hereinafter called the Aldrich amendment) to a tariff bill (H. R. 1438). The Aldrich amendment was designed to tax "every corporation, joint stock company or association organized for profit and having a capital stock represented by shares * * *" (p. 3836). This language was never amended and appears in the Act (36 Stat. 112).

The Aldrich amendment contained no exceptions to its application. On July 2, 1909, Senator Bacon offered an

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[1]Petitioner's counsel acknowledges his indebtedness, for this portion of the brief, to the research by J. O. Kramer, Esq., in connection with the appeal of *Donor Realty Corporation,* 17 T. C. 899 (appeal dismissed by stipulation March 19, 1953).

amendment to the Aldrich amendment which read as follows:

> "Provided, That the provisions of this section shall not apply to any corporation or association organized and operated for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual, but all the profit of which is in good faith devoted to the said religious, charitable, or educational purpose" (pp. 4037, 4061).

Senator Bacon's amendment was tabled after debate (p. 4062). Senator Aldrich during the debate stated:

> "I will say to Senators that my impression is that it would be better for the Senate to adopt the [Aldrich] amendment as it stands. The committee will then consider its effect; and before the bill finally passes they will perhaps have some amendments to suggest with reference to fraternal and benevolent organizations. *My own opinion is that benevolent organizations are all now exempted by the terms of the [Aldrich] amendment as it stands. Of course none of us want to tax that class of corporations,* and if the [Aldrich] amendment should be adopted as it stands, the committee will give very careful consideration to all these propositions for exemption" (p 4049). [Italics supplied.]

On July 6, 1909, the Senate, as in Committee of the Whole, resumed the consideration of the bill. Senator Bacon again offered his amendment (p. 4149) over the objection of Senator Aldrich. During the proceedings Senator Bacon stated that his amendment was necessary because there were corporations, such as the Methodist Book Concern,

> "* * * which is a very large printing establishment, and in which there must necessarily be profit

made, and there is a profit made *exclusively* for religious, benevolent, charitable, and educational purposes, in which no man receives a scintilla of individual profit. Of course if that were the only one, it might not be a matter that you would say we would be justified in changing these provisions of law to meet a particular case, but *there are in greater or less degree such institutions scattered all over this country.* If Senators will mark the words, the [Bacon] amendment is very carefully guarded, *so as not to include any institution where there is any individual profit; and further than that, where any of the funds are devoted to any purpose other than those which are religious, benevolent, charitable, and educational.* It is guarded *so as not to include in the exemption any corporation which has joint stock or in which any individual can receive a dividend for his personal use,* and it is further guarded *so as not to include any corporation which assesses any part of its revenue for any purpose other than those which are mentioned—religious, benevolent, charitable, and educational"* (p. 4151). [Italics supplied.]

Senator Flint then asked Senator Bacon "whether or not, in his opinion, we have not exempted them by the words 'corporation, joint stock company, or association organized for profit?'" Senator Bacon replied:

"I think not, Mr. President. I have the illustration of the Methodist Book Concern for that reason. *It is organized for profit, but it is not organized for individual profit. It is organized to make a profit to extend religious work and to extend benevolent work, charitable work, and educational work. It is organized for profit and does make a profit. That is the very reason why I think the words of the [Aldrich] amendment with a reference to a corporation tax are not sufficient* * * * There is but one word

that I can suggest to make that [the Bacon amendment] stronger, which I am willing to incorporate, and that is after the word 'operated' to insert the word 'exclusively' so that it will read in this way:

"'*Provided,* That the provisions of this section shall not apply to any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual, but all the profit of which is in good faith devoted to the said religious, charitable, or educational purpose.'

"It seems to me that would make it as complete as it is possible to do" (p. 4151). [Italics supplied.]

Senator Bacon then concluded by stating:

"That [the insertion of the word 'exclusively'] will make it much more emphatic" (p. 4151).

After further discussion the Bacon amendment was modified as to form but not substance, reading as follows:

"*Provided, however,* That nothing in this section shall apply to labor organizations * * *; nor to any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual, but all of the profit of which is in good faith devoted to the said religious, charitable or educational purpose" (p. 4156).

It was in this form when the Senate passed the bill two days later (p. 4316). It then went to a committee on conference.

The conference report was read to the Senate on August 2, 1908, two days after the House of Representatives had

accepted it (p. 4755). The committee on conference had agreed to an amendment to the provision in question which was reported out as follows:

> "Sec. 38. That every corporation, joint stock company or association, organized for profit and having a a capital stock represented by shares * * * shall be subject to pay annually a special excise tax * * *: *Provided, however,* That nothing in this section shall apply to labor, agricultural or horticultural organizations * * *, nor to any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual" (p. 4778).

The Senate agreed to this version by accepting the report on August 5, 1909 (p. 4949) and in this form it was approved by the President (36 Stat. 112, 113).

Thereafter in each Revenue Act, and ultimately in the Internal Revenue Code, Congress has on eleven occasions reenacted the exemption provisions in substantially the same form. Today all the original words, except two, remain. Subsequent amendments have both provided further exemptions and limited the activities of exempt organizations to those which do not encompass carrying on propaganda and attempting to influence legislation. The two words which have changed are "income," which now reads "earnings," and "stockholder," which has been replaced by "shareholder," changes which are not material to the issue.

The foregoing early legislative history clearly shows that a corporation, organized for profit, could be exempt provided that it was not organized for individual profit and provided further that the profits were devoted to re-

ligious, charitable, or educational purposes. Such legislative history clearly then supports the majority of the jurisdictions which have decided this issue.

The later legislative history of the Internal Revenue Code Section 101(6) serves only to buttress petitioner's position. With the view to increasing the revenues, in 1942,

> *Hearings before the House Ways and Means Committee on Revenue Act of 1942, Vol. 1, p. 89,*

and again in 1943,

> *H. Report 871,* 78th Cong., 1st Sess., p. 24;
>
> *S. Report 627,* 78th Cong., 1st Sess., p. 21,

Congress had before it for consideration the matter of changing Internal Revenue Code Section 101(6) to overcome the cases granting exemption which have been discussed above, but the section was left unchanged. It was not until 1950 that a change was made. This change was "on a wholesale scale" made "for reasons of policy rather than simply for the collection of additional revenue;" it is important to note that "the Congress specifically provided that no implication should be drawn from the amendments of 1950 as respects the previously effective exemption."

> *C. F. Mueller Co. v. Com'r,* 190 F. 2d 120 (C. A. 3rd, 1950).

This Court has joined the Third Circuit in stating that the 1950 amendments "declared a different rule" for tax years commencing after December 31, 1950, than had prevailed previously.

> *Squire v. Students Book Corp., supra.*

Thus Congress itself has simply fortified the conclusion that the *Sagrada* and *Roche's Beach* rule of the controlling significance of destination was the law in effect during the tax periods of petitioner which are here involved, and that such law should be followed in the instant case. It is submitted that this is particularly true because of the justifiable and unreproachable reliance by petitioner and its founders upon the uniform state of the law existing at the time of petitioner's organization.

(3) The Destination of Petitioner's Income Was Religious and Charitable.

On the assumption that this Court is ready to adopt the position that the destination is more important than the source of income in the determination of petitioner's exempt status, there yet remains the question as to what the destination of petitioner's income, in fact, was. Petitioner submits that the answer to this question is that the destination was exclusively charitable and religious within the intendment of Internal Revenue Code Section 101(6).

It has been previously noted that petitioner's Articles themselves expressly so state. Moreover, the founders of petitioner testified to the same effect [R. 19, 26]. Such intentions, as expressed in the Articles and in the Record, serve to show that the destination of petitioner's income was exclusively religious and charitable, for they establish that none of such money was to inure to the benefit of any private individual personally interested in petitioner. This conclusion is further bolstered by the affirmative injunction appearing in the Articles that "This corporation is one which does not contemplate pecuniary gain or profit to the members thereof * * *."

There is next to be considered, however, the admitted absence of an express prohibition in the Articles against the return of assets to petitioner's founders on dissolution. If dissolution were to take place, the distribution of petitioner's assets to its founders would do violence to all that has been mentioned above. Such a factual situation is not to be assumed,

> *Goldsby King Memorial Hospital,* T. C. Docket 204, memo. op., 7/19/44;
>
> *Koon Kreek Klub v. Thomas,* 108 F. 2d 616 (C. A. 5th, 1939)

particularly where, in the minds of petitioner's founders, a contrary result obtained. Thus, Eaton testified [R. 18]:

> "I realized when I made a contribution to set up the foundation of $50,000.00 that I had known that none of that money, not one penny of it, could ever come back to me in any way. I knew that when I gave it."

Eaton further testified [R. 19]:

> "Well, like I stated before, it has always been in my mind and I have always understood and have taken for granted that the money, the assets of the foundation would go to the charities and to the Christian organizations that are listed in the Minute book, those approved, because that is what it was set up for in the first place, and there is no desire to do anything else with it. There has never been any idea of anything else."

In this connection Eaton's answer to the question asked in the exemption affidavit in 1948 is also enlightening [R. 19, 20].

Moreover, as the Record shows [R. 17, 26] dissolution of petitioner is, at best, a remote possibility and as

such is to be ignored in determining petitioner's exempt status.

Miss Harris' Florida School, Inc., B. T. A. Docket 100054, memo. op., 5/28/40 (Appeal dismissed C. A. 5th).

In connection with this subject, attention is called to the stipulation entered into between petitioner and respondent. Paragraphs 12(a), 13(a) and 14(c) [R. 3, 4, 5] refer to transfers whereby the Eatons *"gave to petitioner without consideration"* certain assets and refer further to acceptance by the Board of Directors of petitioner of *"said gifts."* This language of the stipulation is to be accorded its natural meaning.

Weaver v. Com'r, 58 F. 2d 755 (C. A. 9th, 1932).

Thus, the interpretation of an absolute gift should be preferred by the Court in the instant case over any interpretation connoting a conditional or qualified transfer with strings attached.

The remote legal possibilities which perhaps can be found in petitioner's articles are to be measured, not by technical legal doctrine, but rather in the light of the actual facts of the case. This position is supported by the language of the Board of Tax Appeals in *Unity School of Christianity, supra,* wherein, at page 70, the court stated:

> "By its charter this corporation might lawfully have been used as the means of increasing the wealth of its founders and stockholders. But the evidence is all to the effect that this was never the purpose or intent and has not been the effect. Looking to the purpose, as the statute requires, it becomes a question again of fact, as disclosed by evidence, and this is not determined by what might otherwise have been consistent with the charter."

It is recognized that this particular phase of the discussion might more properly be placed in the section of this brief dealing with the "inurement of earnings" test, since it deals with the question of the receipt or possible receipt by interested individuals of benefits from petitioner. But the isolation of particular facts into a single doctrinal pigeonhole is often difficult in this type of case. Nonetheless, in this connection petitioner wishes to call particular attention to the use of the word "inures" in Internal Revenue Code Section 101(6) rather than the use of such term as "could inure to" or "might inure to." The present tense of the statutory language leads one to the conclusion that Congress had in mind granting an exempt status *so long as* certain conditions were met, and denying them when other conditions might prevail at a later date. This conclusion finds support in *Koon Kreek Klub v. Thomas, supra,* where the 5th Circuit stated (p 618):

> "* * * [T]he exemption applies to profits *so long as* they are retained by the organization or used to further the purposes which are made the basis of the exemption, and are not otherwise used for the benefit of any private shareholder." [Emphasis supplied.]

The Tax Court in *Goldsby King Memorial Hospital, supra,* quoted the above language with approval, and held, as did the *Koon Kreek Klub* case, that the possibility of gain on dissolution would not affect the determination of the exempt status of an organization for an earlier year.

An additional basic question raised in this case relates to the matter of retention of a portion of petitioner's

earnings in place of the current distribution of the whole thereof. It will be assumed at this point that no question can be raised as to the justification from petitioner's standpoint of the retention of a portion of its earnings, and that such retention was not a matter foreign to the achievement of its sole purpose of donating to charitable and religious organizations.

It is submitted that such retention of current earnings does not destroy an otherwise exempt status. In the famous *Mueller* case, *supra,* the taxpayer had borrowed $3,550,000.00 from the Prudential Insurance Company of America, repayable within fifteen years. The loan agreement required that 75% of the income of the taxpayer be used to reduce the loan to $1,500,000.00 and that thereafter payments to New York University could not exceed 25% of the excess of the net earnings over the net losses of the taxpayer until the debt was paid. Significantly, neither the Tax Court in denying exemption nor the Third Circuit upholding it, ever mentioned the contractual non-availability of an appreciable portion of the taxpayer's net earnings.

Likewise, in *Goldsby King Memorial Hospital, supra,* the taxpayer's income was completely absorbed by the liquidation of a mortgage, the construction of additional facilities and the purchase of equipment. Despite this use of net earnings, the Tax Court held that the statutory exemption applied.

Thus if, in the instant case, it is agreed that the ultimate destination of petitioner's income and assets was charitable and religious, the mere retention of income in a particular year would appear to be non-determinative of its exempt status.

On this subject, the Record is significant. On cross-examination, Eaton was asked [R. 21]:

> "Q. You were aware, were you not, Mr. Eaton, that under the Articles of Incorporation that the directors of the foundation were not required, actually required to turn over any money to any charities, that it was a matter left entirely to their discretion. You understood that?"

To this question, Eaton replied [R. 21]:

> "A. I understood it to this end only, that we had the position of directing that money, but *I never did have any understanding that any of the money would not go to charities, but always that it would go there.* There is no question in my mind or has there ever been." [Italics supplied.]

It is submitted that such expressions of purpose and intention, when considered in the light of all surrounding circumstances and of the applicable law, compels the conclusion that petitioner was operated exclusively for charitable and religious purposes.

Conclusion.

Petitioner respectfully submits that it satisfies all conditions laid down by Internal Revenue Code Section 101(6), as said conditions are revealed by the legislative history of that section and by the cases decided thereunder, and is therefore entitled to an exempt status. The Tax Court should be reversed.

Respectfully submitted,

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Dated: January 12, 1954.